

# Musings from the Chief Economist

## Subprime meltdown? Will the damage be contained to Wall Street or spread to Main Street?

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In March, we wrote a piece entitled “Will Mortgage Delinquencies Derail the Economy?” At that time, we concluded that the anxieties over the recession in housing and the rise in subprime problems were overblown and that there was little systemic risk to the overall economy. We also suggested that the setback in stocks occurring at that time was a buying opportunity. Since then, the S&P 500 has advanced about 9%.

Currently, the market is facing anxiety over problems with some of Bear Stearns’ hedge funds and concerns that upcoming resets of adjustable rate mortgages will increase delinquencies. As we saw earlier this year, stocks have corrected and appear to be consolidating their recent gains.

We continue to believe that the greatest impact from the subprime issue will be on banks, which will likely see profits squeezed on the margin. As you may recall, these loans are a very small portion of well diversified portfolios of loans and investments. Major lenders have securitized their mortgage portfolios, repackaging and selling loans to institutional and wealthy investors, which helps to spread the risk. In addition, most major lenders hedge their mortgage exposure and are very adept at managing risk. In summary,

although banks may make less money and temporarily be more judicious in their lending standards, we feel there is little danger of a financial crisis.

As we have already seen from the experience at Bear Stearns, there will be greater pain for funds and their sponsors who held this debt in a highly leveraged manner. In the case of Bear Stearns, the parent company came in to support their funds; for smaller shops, the work-out may not be so favorable.

While we would argue that the damage will be contained to Wall Street, others claim that the damage will be felt on Main Street—that overpriced real estate will continue to fall in value due to the rising inventory of unsold homes, consumer net worth and confidence will decline, and consumer spending will be curtailed as rates on adjustable rate mortgages reset. By this thinking, we are on the verge of a vicious cycle that will push the U.S. into a severe recession.

### **Home prices are not collapsing**

Easy lending conditions did help propel home prices higher and create bubble conditions in some areas. However, in our opinion, a collapse in home prices that triggers a recession is not the most likely outcome. This housing recession has been no more severe than in past

cycles. While home sales have fallen, they have dropped from artificially high levels. The current level of sales is still relatively high, but importantly, it is probably sustainable. Although the current inventory of unsold homes is elevated, it is lower relative to this point in other housing cycles (during which home prices didn’t collapse). The national median existing home price was down 2.4% year-over-year in May, but is still up 50% from the start of this decade.

### **The Fed is not a passive bystander**

While home sales have slowed, family formations (a strong indicator of housing demand) have continued to rise and pent-up demand for housing is building. If housing gets into real trouble that threatens to pull the entire economy into recession, we believe the Fed will quickly lower interest rates. This should draw in the pent-up demand, thereby helping to stabilize the housing market.

### **The resetting of adjustable rate mortgages is not a big deal**

According to some estimates, there are about \$500 billion in ARMs to be reset this year and \$700 billion to be reset in 2008. If the average reset is 200 basis points (2.0%), the extra interest payment in 2007 would be \$10 billion and \$14

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billion in 2008. The increase in interest payments would only be about 0.10% and 0.14% of the almost \$10 trillion in disposable income. Although many homeowners will not be able to bear the higher payments and foreclosures are likely to rise further in the subprime area, our analysis suggests the macro impact on overall spending should be minimal.

## **Delinquencies and foreclosures are not shockingly high**

While the trends in high-risk mortgage delinquencies and foreclosures have been rising, they are no worse than in prior housing cycles. According to the Mortgage Bankers Association, at the end of the first quarter, 8.2% of the nearly six million subprime loans were seriously delinquent (90 days or more late). This is up from 6.5% a year ago. Nevertheless, delinquencies are still considerably below the 11.5% peak set in 2002.

The data from the overall mortgage market provides context as well—seriously delinquent loans plus foreclosures of overall mortgages are high, but not shockingly so. At the end of the first quarter, they stood at 2.3% of all mortgage loans outstanding. Over the last two decades, this number has averaged about 1.9%.

Although delinquencies and foreclosures are rising, they are a very small part of the mortgage market and even less when compared to the value of

residential real estate. According to the recent Federal Reserve Flow of Funds data, the total value of residential real estate is about \$21 trillion and there is about \$11 trillion in equity. Even using very aggressive estimates, only about \$300 billion in subprime losses are expected over the next few years. The actual number is likely to be a lot less and should be spread out over a number of years.

## **In summary, a melt-up not a meltdown**

We do not believe there is a systemic risk to the economy or banking sector from problems in the subprime area or housing in general. While concerns make good headlines and are unsettling, they are overblown. We see major lenders as being well diversified and somewhat insulated from problems in the high risk area of the mortgage market. Although the housing market has been in a long slump, those analysts looking for a collapse have been disappointed. Rising delinquencies and foreclosures are normal and could be a sign that we are near a bottom. Things could get worse, but we believe the Fed is unlikely to sit idly by and watch if a crisis unfolds. Rather than expecting a meltdown in subprime mortgages and housing, we are expecting a continued melt-up in stock prices, triggered by healthy economic conditions, rising earnings and modest multiple expansion.

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